DR. KURT RICHEBÄCHER

Utilitas Verlag
Mühlegasse 33
8001 Zürich

Currencies and Credit Markets

No. 189 / 19. January 1989

Stocks are going up, therefore they will continue to go up. The logic isn't exactly Cartesian, but it does apply a rudimentary law of inertia to the movements of markets, and has the added filip of helping technicians earn their daily bread.

John Liscio, Barron's

Highlights:

The big question impacting and worrying the world financial and exchange markets is the fear that the American economy is overheating with sustained upward pressure on interest rates.

One thing is clear: America's manufacturing industry has enjoyed an unexpected boom year, and now its managers see no obvious reason why it should end.

In our view the U.S. economy is not nearly as hail and hearty as many people assume given first impressions of recent strong data. The trouble with many traders and economists is that they don't feel they have time to read the small print.

What are the differing arguments? Just what are the objective facts of the situation?

The near euphoric forecasts for the U.S. economy are fueled by the belief that exports and capital spending, though moderating, will continue to make substantial gains. Consumer spending is expected to strengthen.

Central to our own assessment is the fact that the major engine of recent growth - exports - has stalled as early as March. Capital spending, too, has sharply slowed down.

On top of these strong dampening effects that are already in train comes now a severe monetary tightening. Yes, over-kill by the Fed has not been an unfimilar possibility.

We ask ourselves whether it will take weeks or months yet, until the Fed will ease again.

That could cause quite a rally primarily in the bond market but also in the stock market.

In a somewhat longer run, however, the markets of the major deficit countries are threatened by a plunge of their currencies.

Unfounded worries and newfound real concerns

The big question worrying the world financial and exchange markets is the fear that a seemingly irrepressible American economy is overheating just as the last slack in product and labour markets is being exhausted by expanding demand. Then, as the Fed responds to this worry by pushing up interest rates, upward pressure on the dollar is anticipated, which in turn, may force competitive hikes of interest rates in other countries, also hitting capacity constraints.

That's of course what has been happening since last April when the new rise in short-term interest rates began. But how long will this yet go on? It appears that the consensus sees no slowing down of the U.S. economy before sometime in the second half of this year. The idea is that the economy is now drawing additional energy from stepped-up consumer spending. Most only anticipate a recession in 1990 at the very earliest or as far out as 1991. We find the reality much different.

The chronology of shifting consensus leaves little credibility with current themes as well

Never before, though, have forecasters been changing their views as frequently and sharply as last year. Just a year ago, with the stock market crash fresh in their minds, the great majority of economists at banks, insurance companies, investment firms and universities foresaw a recession in 1988, or in 1989 at the latest.

Soon enough, they realized that these early recession fears had been a false alarm. The North American economy had rebounded with unexpected vigor. The worry of the Fed and markets now turned to economic overheating and inflation. By early August, these inflation fears had become substantial enough that the Fed raised its discount rate 50 basis points to 6.50%.

But as new economic statistics arrived with the usual lag, the numbers again looked weak. Notably, the rise in payroll employment slowed and retail sales flattened. Promptly, forecasts and sentiment in the financial markets changed again, that having been predominantly signalled by a growing enthusiasm for fixed income investments. As the fear of inflation and rising interest rates cooled, the dollar nose-dived.

But the shifting sands of economic debate still did not find solid footing for long. It took only a few new statistics for October and November to again quickly evaporate the prevailing mood. Excellent gains in employment and an apparently vigorous rise in retail sales, again conjured up the picture of a buoyant economy

on the verge of overheating. According to the postulation accepted by the great majority of forecasters and market participants, the U.S. economy was held to be fueled by robust consumer spending emanating from strong employment and income growth.

And now the optimism is wide-spread

That renascent optimism is now enthusiastically echoed within industrial management. According to the National Association of Purchasing Managements's (NAPM) semiannual forecast, purchasing managers predict, by a wide margin of four to one, that business in 1989 will even be better than in 1988. The percentage of NAPM members expressing optimism about the coming year is the highest for any year-end forecast since 1983, which was back in the early boom stage of this recovery. Central to their positive outlook is the belief that exports and capital spending will continue to make substantial gains in 1989, though at a more moderate pace than in 1988.

One thing is clear: America's manufacturing industry has enjoyed an unexpected boom year, and now its managers see no obvious reason why it should end. Such emphasis on mood and expectations reminds us of a remark by Joseph Schumpeter in his book Business Cycles.

> "Optimistic or pessimistic expectations may for a time acquire a causal role. But again it is necessary to warn against over-rating their importance. No great crisis hat ever come about that was not fully explainable by the objective facts of the situation. Expectation not so conditioned never has produced more than short-lived spurts or breaks."

Optimism may be golden but the facts of the situation are clay

The sage observation above begs the question what the objective facts of the economic situation in the United States actually are. Surely the answers, as was demonstrated several times last year, have not been reflected in the ongoing economic debate. Obviously, strong economic momentum in production, employment and income growth has persisted into the fourth quarter. But this momentum is not supported by continued strength in demand. A host of indicators has been pointing to sharply decelerating demand, both foreign and domestic. While industrial production rose at a 7% annual rate in the third quarter, final demand grew only at a 2% annual rate following a 5.8% growth rate in final demand during the first half of 1988.

Real final sales, 1985 to III/88

(Percent changes from preceding period)

1985	1986	1987	III 87	IV 87	I 88	II 88	III 88
4.5	2.8	3.2	5.6	-0.2	5.6	6.0	2.0

Central to our consideration is the fact that the major locomotive of the sudden revival of U.S. manufacturing (and in this case for the economy as a whole) already stalled as early as last March. Between September 1987 and March 1988, U.S. merchandise exports surged, seasonally adjusted, at an annual rate of 50% accounting directly for half of GNP growth during this period. By contrast, over the last eight months, merchandise exports have expanded at an annual rate of barely 5%. After adjustment for inflation, that makes for little more than stagnation and certainly qualifies as being long enough to be marked as a trend.

But the expansionary effect of this previous burst of exports by far surpassed its direct impact on domestic production. In its wake, it triggered an additional capital spending and inventory boom. As all three cumulated, income growth was given a boost, in turn fueling consumer spending.

Now, however, this process has started to work in reverse. Stalled export growth reduces economic growth directly, but in addition also indirectly through weakening investment in plant and equipment. In fact, sharply slower capital spending by business is already evident. The main boom component that still remains in the economy is inventory building.

The first fallacy finds root at the core of the popular theme

What lies ahead for the U.S. economy? What are the differing arguments? Just what are the objective facts of the situation as Schumpeter would say? To answer that we must ask our readers to bear with our detailed focus on those issues. The questions are of over-riding importance and key to our determination that the popular view of a sustainably robust economy is badly misplaced.

Obviously, the experience of an economy that surged despite the stock market crash has reinforced people's belief in the irrepressibility of the U.S. economy. Asked what will generate the strong future growth that they expect, the familiar answer is that buoyant employment and income growth will boost consumer spending more than offsetting any moderation in export growth. The reports of sharply higher retail sales in October and November were, therefore, all grist to the mill for these forecasters.

The Third Quarter is the Starting Point. Our difference of opinion about the economic outlook begins with our contrary interpretation of GNP growth in the third quarter of 1988. The bullish consensus found comfort within what we find to be a rather ridiculous argument. The apparent softening of GNP growth during that quarter was considered an aberration attributable to the summer drought. Without the drought, they assert, growth in real GNP would have been 3.2% instead of the actual 2.5%. Therefore, the true underlying growth rate must still be above a noninflationary threshold. Hence, the general conclusion: The Federal Reserve has so slam on the brakes in order to prevent imminent overheating.

Broadly and Conclusively the Facts Say Otherwise. Our careful reading of third quarter data yields a starkly contrasting conclusion. We noticed sweeping changes on the demand side which expose the grandiloquent drought effect as another misleading exercise in statistical prestidigitation.

Firstly, we noted that foreign trade, after having delivered half the GNP growth in the prior four quarters, had turned slightly negative in its contribution to GNP growth.

Secondly, what struck us as a highly important new feature was the fact that business had drastically trimmed its spending on durable equipment from a 20% annual growth rate in the first half of the year to a 4.6% annualized rate.

The downturn in these two vital factors has in total reduced GNP growth by more than 3% at an annual rate during the third quarter. And most important, this is final demand, while the drought effect is nothing more than a statistical fiction about growth on the fields (affecting farm inventories). The stark fact is that in the midst of the preoccupation with the drought it went unnoticed that final sales slumped to a 2% annual growth rate, following 5.8% in the first half of the year.

Given all the heated talk of an impending consumer boom, we also took a close look at the pattern of consumer spending. Any such boom must primarily show up in durable goods. However, on examination it is precisely these categories that were weakest in the consumer sector as the following table illustrates.

<u>Consumer spending on goods, III 87 to III 88</u>

(Seasonally adjusted at annual rates, billions of 1982 dollars)

	III 87	IV 87	I 88	II 88	III 88
Durable goods	15.2	-18.9	13.5	9.5	- 0.2
Nondurable goods	2.1	- 1.4	12.3	8.9	14.1

Some further facts: consumer spending on durables and non-durable goods was just 1.1% higher than in the corresponding third quarter of 1987 in real terms. Around 60% of incremental consumer money went into services, a lot of which looks like "essentials" or "involuntary expenditures" such as housing, transportation, education and medical care. The three biggest items contributing to the rise in consumer spending during the third quarter were clothing, medical care and - no joke - air conditioning (due to the summer heat). Air conditioning increased GNP growth a little over 0.3% while the apparent drought effect reduced it 0.6%. And there's no telling how much of clothing expenditures may have been triggered by the heat as well.

So there we have it. Weakness in growth was evident in two important sectors: capital spending and exports. Strength in consumer spending was centered in services and non-durables with no support from durables. And in the latter case, the few pockets of strong demand actually counterbalanced the statistical drag produced by the drought.

The state of the consumer: no boom there either

What, then, about the retail sales "boom" that is being proclaimed from all sides? We can only say, wait and see. The fact is that U.S. retailers across the board, and not only auto dealers, very early in the pre-Christmas season felt it necessary to boost disappointing sales with sizable rebates. While in the end, year-over-year comparisons may show impressive increases, we should remember that last year's retail sales at this time were severely depressed by the stock market crash. That makes comparisons suspect and certainly distorts seasonal adjustments for the period. Furthermore, huge stimulative rebates may inflate sales in the short-term, but it is nonsense to use this as proof of a boom. To a large extent, these purchases will have been borrowed from future demand. That causes us to view the sales figures for November and December as again subjects of only transient enthusiasm.

This applies particularly to auto sales which account for more than one fifth of total retail sales. Recent sales may exceed those of a year ago, at the time of the stock market crash, by a substantial margin, but they are very poor when compared with sales levels in late 1986.

In a concerted search for any possible or real consumer boom, we combed the host of data from many perspectives. In sum, one theme is obvious as the following table shows. A distinct rise in sales occurred early in 1987. Ever since, sales in real terms have held flat with only minimal fluctuations.

Sales of retail stores, constant (1982) dollars

	Jan.	Febr.	March	April	May	June	July	August	Sept.	Oct.
1988	114.8	116.5	117.8	116.7	117.1	117.5	117.7	117.8	116.8	117.4

Source: Business Conditions Digest, U.S. Department of Commerce, November 1988, p. 65.

As clear as our conclusions may appear, it is actually the reported increases in the monthy figures that catch the attention of the financial markets. They look rather better because they are not adjusted for inflation. What is overheated here is rather obvious. Ostensibly, its not the consumer but rather the people interpreting the numbers.

In addition to retail sales, the Department of Commerce publishes wider aggregates on "consumer expenditures" which include spending on services. Again we can only ask the reader to take a look at these figures and to tell us where there is any sign of a consumer boom. We are at pains to find any supporting evidence.

Personal Consumption Expenditures

Billions of constant (1982) dollars

	May	June	July	August	September	October
Personal outlays	11.8	26.0	-3.0	17.7	-15.9	14.6
Durable goods	3.7	9.3	-7.6	2.8	- 5.6	- 1.9
Nondurable goods	5.4	5.6	1.9	8.4	- 6.4	3.6
Services	2.6	11.1	2.8	6.4	- 3.8	12.7

Source: Personal Income and Outlays, Department of Commerce, Press Releases.

Employment data provides grist for conflicting interpretations as well

In particular, it has been the very strong employment numbers that have recently spooked the financial markets. Here, too, reported net figures are taken as the full gospel even though strong statistical differences even exist between the two authoritative surveys. According to one survey, employment in the United States has risen by 2.2% last year, yet the other avers a higher growth rate of 3.6%.

One survey - the so-called Household Survey - is based on a sample of 55,800 households which are carefully selected to reflect the entire non-institutional population of age 16 years and older. The other recognized measure, called the Establishment Survey, is derived from a sample of 300,000 private and public establishments employing over 38 million people. Over time, both surveys have always tracked each other fairly closely. For example, in 1987 both sources unanimously reported employment growth of 2.8 million. But since last year reported figures have been grossly out of step with each other. As might be guessed however, the subject of publicity and market attention has almost exclusively been centered on the stronger figues of the Establishment Survey.

The discrepancy between these two surveys and its explanation does throw some light on the origins of this apparently fantastic job creation. More and more Americans (above all women) are taking second jobs. As the Establishment survey counts jobs, its results are therefore duly inflated. By contrast, the Household Survey only counts employed persons. Being doubly employed in the latter measure still only counts as one job. In fact, the major growth has been in part-time employment. In recent months, it accounted for two-thirds of all gains.

The critical factors underlying expectations are suspect

What indeed then are the critical assumptions underpinning the popularly bullish outlook for the North American economy in 1989? This near euphoric outlook is fueled by the belief that exports and capital spending will continue to make substantial gains, albeit at a more moderate pace. Any moderation on these counts is supposed to be more than offset by stronger consumer spending.

It is precisely with these two engines of growth of the present U.S. economic recovery, namely exports and capital spending, that we find the first decisive fallacy in these current arguments for a continuing strong economy. Though widely ignored, as we have pointed out, it is actually an established fact that both have already badly faltered.

That's not the only grave fallacy underlying the forecasts of persistent strong growth. The other one lies in the assumption that buoyant employment and income gains could largely or partly replace exports and investment as the driving force of this expansion. But, as most should know, production, jobs and income growth are always sequential in the cyclical process, not causal. If all three performed so well in the past year, it was because of booming exports and investment. But as these two fall away, so will job and income growth. Coming full-circle, that brings us right back to the causal question of prospects for exports and investment.

Exports are the critical focus

If exports have been the engine of growth for more than a year, the first thing to check when trying to assess the thrust of the economy, is the state of that original machinery. In short, it is in poor state. By now, there is truly overwhelming evidence that it has lost any pulling power. As already mentioned, exports, particularly export volumes, have been rather flat since March with minimal fluctuations since that time around a level of $27 billion per month. That occurence in itself is quite ominous if one considers that domestic demand in the other industrialized economies, in spite of slowing somewhat, is expanding considerably faster than in the United States.

In answer to that apparent divergence many economists cite capacity constraints as the main reason for the disappointing performance of U.S. exports. That may be the case in two or three industry sectors - paper, chemicals and primary metals. But as is obvious from the data, the slowdown in exports is not confined to these sectors. Consequently, we must reject the idea that capacity contrainst have been the chief inhibitor to export growth.

Underpinnings to business capital spending are weakening

The second main engine for the U.S. economic recovery was business capital spending. Again, as already highlighted, its growth rate was already sharply down in the third quarter to 4.6% from 20% in the first half. Whether that was a fluke or something more is an important question. In our opinion, two tell-tale developments foreshadow further weakening in capital spending: firstly, two recent surveys of business capital spending intentions; secondly, weak order inflows for new machinery.

Spending Intentions Faltering. The most recent survey, conducted in October and November, comes from the U.S. Department of Commerce. Two statements from that report aptly clarify the situation. Estimates of real spending for 1989 indicate a 3.5% increase by Manufacturing. That compares dourly with the lastest estimate for real spending increases in Manufacturing for 1988 of 12.7% over 1987 levels. If industries were genuinely bumping up against capacity ceilings, it is certainly very strange that they should so sharply curtail their investment plans, especially in light of wide-spread bullish prognostications. And if the truth be known, most of the forecast increase is for the first quarter of 1989.

Machinery Orders Have Been Enthusiastically Mis-interpreted. The other indicator of shaky capital spending prospects are, of course, new orders for machinery. But as capital goods account for around 30% of U.S. merchandise exports, they reflect in reality a

mixture of investment and export trends. Recent press reports on U.S. manufacturing's new orders make highly confusing reading. The reasons are huge and erratic movements in new orders for defence and civilian aircraft (Boeing). But since the Commerce Department categorizes data by industry segment it is easily possible to sort out any distortions if the time is taken.

Yet the media continues to fabricate a bullish backdrop purely on the face value of aggregated numbers. A small example in this regard. The commentary to the November report published by The Wall Street Journal stated: "Further indicating continued economic strength, new orders for goods from U.S. factories climbed 0.3% in November ...Economists were especially encouraged by a 3% increase in orders for capital goods other than defence equipment, commonly regarded as a barometer of industry investment plans. The strong order picture indicated that the capital-spending boom will continue in 1989."

To complete the picture, here are several comments transcribed from the actual Commerce Department report that we regard as relevant:

> "New orders for manufactured goods in November increased $0.6 billion or 0.3%. Orders reached a high in June at $228.1 billion, but have been somewhat volatile since then, averaging $224.9 billion per month."
>
> "Although total new orders were up slightly, the specific major industries showed more significant changes. Within durables, the largest increase was in electrical machinery, up $1.6 billion or 8.3%; most of the increase was in defence communication equipment. The largest decline was in transportation equipment, down 6.1%. Virtually all categories except commercial aircraft declined."

What leading economists called an "encouraging 3% increase for capital goods" on closer inspection reveals itself as just a big order for commercial aircraft. Without it, capital goods orders in reality would have fallen by 1.6%, following a small rise in October of 0.4% and a decline in September of 6.2%. In our humble interpretation that's hardly a boom.

Backlogs Show the Same Bias. That brings us to another point that plays a great role in the bullish forecast for the US economy. It is continued bulging order backlogs. Over the past twelve months, these backlogs have risen by $42 billion or over 10%. Here the unevenness of these reports is again evident. Aircraft orders alone, mainly Boeing, account for $27 billion representing more than 60% of this increase. Clearly, most of these orders will go into production only in later years.

It all adds up to a colder reality

In our view the U.S. economy is not nearly as hail and hearty as many people assume given first impressions of recent strong employment and retail sales data. Even if these were not illusory, we still wouldn't see any basis for their continued strength. The export boom was the key to the past sharp recovery of industrial production. As explained in the last letter, both exports and capital spending had accounted for 80% of real GNP growth between mid-1987 and mid-1988. Now, since they have weakened drastically, a corresponding impact on the whole economy should follow with a short lag.

On top of this strong dampening effect that is already in train comes now a severe monetary tightening. Taken together with much weaker exports and business investments, this could slow down the economy much more quickly than seems feasible today. And to add possible injury, the strength of this economy is not deep-seated. High debt levels add a vulnerability that did not exist in previous post-war cycles.

What will be the response of the Fed?

Admittedly, it has astonished us how severely the Federal Reserve has reacted to the employment and retail sales data. Given all the other evidence of generally weaker demand, these indicators appear doubtful. But with production resources close to full capacity and inflation already well above 4 %, the Fed has obviously decided that only inflation, not recession, is the current major threat to sustained economic expansion.

We think that the advocates of this policy may well underestimate the dynamics of a slowdown when weaker exports, investments and a retrenchment by the consumer cumulate. The consumer is not the key to economic growth at this phase: export and investments are and they have slowed down - drastically.

From this perspective, the industrial recovery that started in early 1987, has passed its cyclical peak. Inventory accumulation might yet mask the downturn, but when sales slow, inventories quickly reach excessive levels. Companies thereupon cut their buying. Industrial production declines.

For these reasons, we don't expect a substantially tighter monetary policy by the Fed, if at all. Yes, over-kill by the Fed has not been an unfamiliar possibility. The next economic data will be crucial. But we recommend, as we have done throughout this letter, that one look to the composition of GNP and in particular at final demand, exports and capital spending.

Capital markets will then likely exult for a time

We ask ourselves whether it will take weeks or months yet, until the Fed will ease again as evidence of a slumping economy becomes overwhelming.

How will this affect the U.S. financial markets? As soon as they recognize a weakening economy, they will undoubtedly anticipate easier money. That could cause quite a rally primarily in the bond market but also in the stock market. It is not unusual for the stock market to make a strong advance after the cyclical peak in business activity is recorded.

An additional bullish case is to be found in the high levels of cash held by the U.S. mutual funds and in the fact that pension funds have the lowest level of equities in their portfolios in more than 20 years.

Not to forget that in the past twelve months, New York - together with London, Toronto and Sydney - have been the trailing caboose of the international stock market train.

In the somewhat longer run, however, the markets of these major deficit countries are threatened by a plunge of their currencies. The present strength of these currencies is based on the idea that, given buoyant economies, the central banks have to keep interest rates high or push them even higher to fight inflation. Lower interest rates associated with weakening economies will pull this crucial prop from under these currencies.

With the benefit of hindsight, we would say today that the sharp decline in the U.S. dollar in October/November had in reality little or nothing to do with president-elect George Bush and the budget deficit. The operative factor was the apparent weakening of the economy over this period of time.

The dollar and all the other high-interest rate currencies will stay strong as long as the economies of these countries appear to be strong and tight monetary policy is supposed to continue. But now longer. Whenever these economies will finally weaken and their monetary policies ease, the critical phase both for these currencies and their financial markets begins.

Publisher: Utilitas Verlag AG, Mühlegasse 33, 8001 Zürich

Editor: Dr. Kurt Richebächer.

Annual subscription: SFr. 600.– / US-Dollar 400.– for subscribers outside Europe.

Languages: German /English